



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/04/08	Bill No:	AB 1881
Tax:	Sales and Use	Author:	Tran
Related Bills:			

BILL SUMMARY

This bill would stop the accrual of interest on unpaid sales and use tax liabilities during the pendency of a Chapter 7 bankruptcy proceeding of a small business, as defined.

ANALYSIS

CURRENT LAW

Under existing law, persons who pay their sales and use tax obligations after the date they are due are required to pay a penalty (10 percent of the tax), plus interest on the unpaid tax from the date the tax was due to the date it was paid. The interest accrues monthly on the unpaid tax and is currently at a rate of 11 percent through June 30, 2008.

Under existing law, Article I, Section 8, of the United States Constitution authorizes Congress to enact “uniform laws on the subject of bankruptcies.” Under this grant of authority, Congress enacted the “Bankruptcy Code” in 1978. The Bankruptcy Code, which is codified as Title 11 of the United States Code, is the uniform federal law that governs all bankruptcy cases filed in the United States.

Several basic types of bankruptcy cases are provided for under the Bankruptcy Code, and the cases are traditionally given the names of the chapters that describe them. Chapter 7, for example, entitled “Liquidation,” contemplates an orderly, court-supervised procedure by which a bankruptcy trustee liquidates the nonexempt assets, if any, of a debtor’s bankruptcy estate, reduces them to cash, and makes distributions to creditors pursuant to a scheme of priorities established under the Bankruptcy Code, subject to the rights of secured creditors. Other types of bankruptcy cases include those filed under Chapters 9, 11, 12, and 13.

A bankruptcy discharge is an order issued by the court that extinguishes the personal liability of a debtor for all discharged debts. The companion discharge injunction prohibits creditors from taking steps to collect discharged debts from the debtor. Although a bankruptcy discharge releases the debtor from personal liability for certain debts, it does not prevent a secured creditor from seeking to enforce a valid lien against the debtor’s property. In a Chapter 7 bankruptcy case, a discharge is only available to individual debtors, not to partnerships or corporations. If an individual debtor is eligible to receive a discharge, then the court usually issues a discharge order four to six months after the commencement of the debtor’s case.

With respect to individuals in Chapter 7 cases, some debts are dischargeable, and others may be “non-dischargeable” depending on particular circumstances. Sales tax debts, for example, are non-dischargeable in a Chapter 7 bankruptcy case unless all of the following apply:

1. The tax return on which the tax debt arose must have been due at least three years before the filing for bankruptcy;
2. The tax return was filed at least two years before the filing for bankruptcy;
3. The taxes were assessed by the Board at least 240 days before filing;
4. There was not a fraudulent tax return or a willful attempt to evade paying taxes; and
5. A tax return, if required, was filed before the commencement of the bankruptcy case.

A discharge of interest and penalties on taxes follows the tax liabilities on which they are computed. That is, if an underlying tax liability is dischargeable, so is the interest and penalty on that tax liability. On the other hand, if the underlying tax liability is non-dischargeable, the penalty and interest accruing on that tax liability are likewise non-dischargeable.

PROPOSED LAW

This bill would add Section 6593.7 to the Revenue and Taxation Code to provide that a qualified tax liability shall not bear interest during the period in which a qualified small business has a case pending under Chapter 7 of Title 11 of the United States Code.

The bill would define “pending” to mean the period beginning on the first day of the month following the date the bankruptcy petition is filed, or if the case is converted from another chapter to a Chapter 7 case, on the first day of the month following the date the case is converted, and ending on the last day of the month following the date that the case is closed or converted to a case under another chapter of the Bankruptcy Code.

The bill would also define “qualified small business” as a trade or business that has average annual total sales of less than \$1 million, as specified.

In addition, the bill would define “qualified tax liability” as a tax liability that is due and payable to the state as of the date the qualified small business filed a bankruptcy petition under, or converted a bankruptcy case to, Chapter 7 of the Bankruptcy Code.

The bill provides that this section shall not apply if the case pending under Chapter 7 of the Bankruptcy Code is dismissed.

The bill would take effect on January 1, 2009.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by Board of Equalization Member Michelle Steel in order to correct a perceived inequity in the law. According to Board Member Steel, one of the primary purposes of bankruptcy is to discharge certain debts in order to give an honest individual debtor a “fresh start.” The accrual of additional interest during the pendency of a bankruptcy case deviates from this concept. Also, under bankruptcy law, a debtor’s assets (including cash) at the time a petition for bankruptcy is filed become property of the debtor’s bankruptcy estate, and the debtor is prevented from using those assets to satisfy past tax liabilities. However, those assets may be liquidated to pay a claim for the tax liability within the bankruptcy case. It is inequitable that interest would continue to accrue when a taxpayer may not use those assets to satisfy its past tax obligations.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board’s formal position.

2. **Income earned after the petition is filed may be used to pay the tax.** Under current law, while assets of a bankruptcy estate may not be used by a debtor to satisfy past tax obligations, any income a taxpayer receives *after* the petition in bankruptcy is filed may actually be used to pay outstanding liabilities. Should a debtor be relieved of the interest accruing during the pendency of a bankruptcy case when the debtor earns income after the petition is filed?
3. **Should interest stop accruing for partnerships and corporations?** Partnerships and corporations do not receive a discharge of their debts in Chapter 7 cases. Rather, their assets are liquidated, and the proceeds are distributed to creditors based on the priority of the creditors' claims. Under this bill, interest would not accrue on the unpaid sales and use tax liabilities of a partnership or corporation until complete liquidation of assets (for which interest would be waived under this proposal) which could take years to complete.

COST ESTIMATE

Enactment of this bill would result in administrative costs attributable to making the necessary interest adjustments. An estimate of these costs is pending.

REVENUE ESTIMATE

There are approximately 1,140 currently open Chapter 7 cases in the Board's inventory. We do not have precise data to determine how many of those cases are "small businesses" within the meaning of this bill. Often, larger businesses tend to liquidate under Chapter 11, leaving Chapter 7 to the smaller businesses. We estimate that about 90 percent of the 1,140 cases (representing \$244 million in tax), or 1,000 cases would be affected by this bill.

Outstanding claims for these cases amount to about \$171 million in tax (excluding interest and penalty). However, these are only the asset cases for which we are allowed to file claims. Asset cases represent about 70 percent of all the Chapter 7 cases in the Board's inventory, so assuming the amount owed for both types (asset v. no asset) is similar, then the estimated tax amount for which no interest would accrue pursuant to this bill would be approximately \$220 million (70%/171 million ~ 100%/244 million x 90%).

Cases under Chapter 7 can close in as little as four months, or remain open for years. The case length is so uneven and so case specific that an average is difficult. Assets are liquidated and the sales proceeds distributed by a bankruptcy trustee to pay creditors who file claims based on a priority scheme defined by federal law. Some asset sales, such as real property, or assets subject to disputes and litigation, may involve years of effort to resolve. For purposes of this revenue estimate, we have conservatively estimated that on average, the pendency of a Chapter 7 case is 8 months. The current annual rate of interest is 11 percent or .9167% monthly.

Accordingly, based on the previous, it is estimated that the total interest that would be affected by this bill amounts to about \$16 million (\$220 million x 8 months x .9167%) annually. However, it is not reasonable to expect the Board to collect this entire amount since many of these cases are closed corporations. On the other hand, for individuals, often our rate of collectibility increases after a Chapter 7 bankruptcy, since those

individuals have received a discharge of other debts, and have more ability to pay their outstanding sales and use tax liabilities that survived the discharge.

If we assume at a minimum that 10% of the interest would be ultimately collected each year on these accounts, then the total annual state and local revenue loss would amount to \$1.6 million, as follows:

State General Fund (5%)	\$1,007,557
State Fiscal Recovery Fund (1/4%)	50,378
Local Revenue Fund (1/2%)	100,756
Local Public Safety Fund (1/2%)	100,756
Local and County (1%)	201,511
Special districts (.69%)	<u>139,042</u>
Total	<u>\$1,600,000</u>

Analysis prepared by:	Sheila T. Waters	(916) 445-6579	03/03/08
Contact:	Margaret S. Shedd	(916) 322-2376	
Is			1881-1sw.doc

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.